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OFFICE OF SECRETARY

April 17, 1995

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Mr. William F. Caton
Secretary
Federal Communications Commission
Room 222
1919 M St. NW
Washington, DC 20006

Re: In the Matter of: Price Cap Performance Review for Local Exchange
Carriers; Treatment of Video Dialtone Services Under Price Cap Regulation,
CC Docket No. 94-1, Further Notice of Proposed Rulemaking.

Dear Mr. Caton:

Enclosed herewith for filing are the original and nine (9) copies of MCI
Telecommunications Corporation's Comments in the above-captioned proceeding.

Please acknowledge receipt by affixing an appropriate notation on the copy of the
MCI Comments furnished for such purpose and remit same to the bearer.

Respectfully,

Michael Hydock
Executive Staff Member
Federal Regulatory

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**Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington DC 20554**

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In the Matter of:

Price Cap Performance Review
for Local Exchange Carriers;
Treatment of Video Dialtone Services
Under Price Cap Regulation

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CC Docket No. 94-1

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MCI COMMENTS

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April 17, 1995

Table of Contents

<u>The Commission Should Affirm its Tentative Conclusion That a Separate Price Cap Basket Will Advance the Public Interest Objectives of VDT</u>	<u>2</u>
<u>A Separate Basket Will Partially Address Cross-Subsidy and Competitive Concerns.....</u>	<u>5</u>
<u>It is Premature to Anticipate Whether All Broadband Services Should be Held in the VDT Price Cap Basket.....</u>	<u>7</u>
<u>The PCI Formula, Productivity Factor, and Consumer Productivity Dividend.....</u>	<u>9</u>
<u>Initial Rate Setting.....</u>	<u>11</u>
<u>Service Categories and Banding.....</u>	<u>11</u>
<u>Sharing Issues.....</u>	<u>12</u>
<u>The Commission Must Establish a Distinct Part 69 Access Category for VDT.....</u>	<u>13</u>
<u>Conclusion.....</u>	<u>16</u>

Summary

MCI agrees with the Commission's tentative conclusion that a separate price cap basket needs to be established for VDT services. In this pleading, MCI demonstrates the following points:

- **The Commission must establish a distinct price cap basket for VDT services. Such a step will decrease the likelihood of cross-subsidy and anti-competitive pricing that use of the current baskets might allow.**
- **VDT services should be rolled under price caps after one year, using the existing productivity factor, cost index, and consumer productivity dividend for the PCI formula.**
- **To complete the process of removing potential cross-subsidy of VDT by access ratepayers, the Commission must require that LECs separately account for VDT investments and calculate sharing for existing interstate services without contamination from VDT returns.**
- **In order to provide for the mechanics of a separate price cap basket, the Commission must create a separate Part 69 bucket for all VDT elements that will prevent the assignment of costs and investments to non-VDT access categories.**

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Washington DC 20554**

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OFFICE OF SECRETARY**

In the Matter of:

Price Cap Performance Review
for Local Exchange Carriers;
Treatment of Video Dialtone Services
Under Price Cap Regulation

CC Docket No. 94-1

MCI COMMENTS

MCI Telecommunications Corporation ("MCI") hereby submits its comments in response to the Further Notice of Proposed Rulemaking ("Notice") in the above-captioned docket.¹ In this Notice, the Commission is seeking comments from interested parties regarding the tentative conclusion that Local Exchange Carriers (LECs) subject to price cap regulation would also have their Video Dialtone (VDT) service rates regulated under the Commission's same price cap rules.² To that end, the Commission released the instant Notice seeking comment on certain policy and operational issues involved in such a regulatory mechanism. In addition, the Commission has recently issued its findings in the Price Cap Performance Review, and

¹ In the Matter Price Cap Performance Review for Local Exchange Carriers; Treatment of Video Dialtone Services Under Price Cap Regulation, CC Docket No. 94-1, Further Notice of Proposed Rulemaking, ("Notice") released February 15, 1995.

² In the Matter of Telephone Company-Cable Television Cross Ownership Rules, Sections 63.54-63.58, CC Docket No. 87-266, and Amendments of Parts 32, 36, 61, 64, and 69 of the Commission's Rules to Establish and Implement Regulatory Procedures for Video Dialtone Service, RM-8221, Memorandum Opinion and Order on Reconsideration and Third Further Notice of Proposed Rulemaking, ("Recon Order") released November 7, 1994.

its findings are related to MCI's Comments discussed below.³ This review, plus the initial price cap orders⁴ presents the framework for evaluating the proper treatment of VDT under price caps.

The Commission Should Affirm its Tentative Conclusion That a Separate Price Cap Basket Will Advance the Public Interest Objectives of VDT

According to the Commission the overall policy goals of VDT include:

...facilitating competition in the provision of video services; promoting efficient investment in the national telecommunications infrastructure; and fostering the availability to the American public of new and diverse sources of video programming.⁵

The construction of an appropriate price cap mechanism of regulation for VDT services will help the Commission fulfill those goals in a manner which gives LECs incentives to develop VDT platforms, while protecting video transport competitors from predatory pricing and access/telephony ratepayers from cross-subsidizing video and broadband network functionality.

As discussed by the Commission, the existing video delivery marketplace has seen an increasing level of competition within it over the last several years.⁶ The Commission did not find, however, that the market was sufficiently competitive

³ In the Matter Price Cap Performance Review for Local Exchange Carriers, CC Docket No. 94-1, First Report and Order, ("Order") released April 7, 1995.

⁴ In the Matter of Policy and Rules Concerning Rates for Dominant Carriers, Second Report and Order, 5 FCC Rcd 6786 (1990) (*LEC Price Cap Order*), Erratum, 5 FCC Rcd 7664 (Com. Car. Bur. 1990), modified on recon., 6 FCC Rcd 2637 (1991) (*LEC Price Cap Reconsideration Order*).

⁵ Recon Order, at ¶ 3.

⁶ Recon Order, at ¶ 5.

enough to allow LECs the ability to offer VDT services without some level of regulatory oversight. Moreover, the LECs' primary business, local exchange telephony services, is marked by a virtual monopoly where the LECs' market shares for local and access telephony services are in excess of 99 percent. Therefore, regulatory oversight of VDT rates, through a mechanism similar to the existing price cap form of regulation of interstate services, is required to prevent predatory pricing funded through a cross-subsidy from its monopoly ventures. Such a form of regulation will give LECs incentives to invest in broadband infrastructure for video delivery and present traditional cable operators with yet another level of competition, beyond what is developing in satellite systems and wireless cable.

However, without a separate basket for VDT services, these all-important policy goals will be short-circuited by the tremendous advantages the LECs could obtain absent such a basket. Without a distinct basket for VDT services, LECs will be able to utilize the existing price cap baskets and pricing flexibility rules to game the system and achieve predatorily low rates for VDT (in order to achieve rapid market penetration), while placing the burden for such low prices on existing telephony and access ratepayers. Such an outcome would be possible if the LECs were able to place VDT rate elements in existing telephony/access baskets and use the pricing flexibility inherent in these baskets to increase telephony rates and lower VDT rates over time. The Commission has already tentatively decided not to restructure its accounting and separation rules for VDT services.⁷ The only remaining source of protection to ensure

⁷ Recon Order, at ¶¶ 172 and 186.

the orderly development of VDT without dangerous cross-subsidy and predatory pricing is the creation of a carefully constructed price cap basket plan for VDT services. Without such protection, it is conceivable that LECs could begin a process that looks like vigorous competition in video delivery, but that ends in the preclusion of any meaningful competition in the video and broadband delivery systems. This could occur if the LECs were able to use revenues from monopoly-based services to cross-subsidize predatorily low VDT rates. Over time, LECs could succeed in driving out cash-strapped cable firms from the wireline video delivery business.

The Commission has positioned price cap rules as a technique to create pricing practices that mimic those under competition.⁸ However, the Commission must recognize that the entire issue of price caps becomes more problematic under a paradigm where the services to be capped are in two relatively distinct marketplaces, with two distinct patterns of competition and customer bases. The services already covered by price cap regulation are offered by LECs under a virtual monopoly situation, and will continue to be for some time. While there has been some limited entrance of competitors into niche markets, the coverage of competition, in terms of the services offered and the customer base that can avail itself to these other suppliers, is extraordinarily limited. VDT services, on the other hand, will be offered in a world where there is more limited pricing rules, and where there is somewhat more competitive alternatives to VDT.⁹ In addition, based upon the level of network

⁸ Notice at ¶ 7.

⁹ Cable firms, for example, are subject to pricing rules for certain programming tiers.

topology, financial resources, and existing technology, telephony firms will find it relatively easier to deploy video delivery than will cable operators provide switched telephone and access services. For these reasons, it is crucial that the Commission develop a separate price cap basket for VDT services, one that is designed correctly and can be used to preclude significant amounts of cross-subsidy.

A Separate Basket Will Partially Address Cross-Subsidy and Competitive Concerns

A separate basket for VDT services will provide an initial starting point in the Commission's desire to alleviate the potential for cross-subsidy and predatory pricing. A separate basket by itself will not provide adequate protection, however. As discussed below, a separate basket, combined with careful new VDT reporting processes and sharing treatment will offer the Commission some assurance that LECs will not endanger the VDT public policy goals

Under the Commission's traditional approach, the case for a distinct price cap basket for VDT services is straightforward. As the Commission noted in the Notice in this proceeding:

“placing two very different services, with different sets of customers, in the same basket is a result [the Commission has] attempted to avoid due to the cross subsidy issues that might arise”¹⁰

The Commission itself has correctly noted that VDT services are significantly different from the other access basket services in certain respects. Although it is unclear to

¹⁰ Notice at ¶ 10 [footnote omitted].

MCI whether the transport element of VDT signaling is effectively different than the transport component for other telecommunication services, VDT content and market differences are sufficient to justify a separate price cap basket. As discussed above, the market for video delivery mechanisms is marked by more options than the services contained within the other price cap baskets. Additionally, while telephone service might be characterized as a virtual necessity in today's environment, the reception of video programming on a pay basis is marked by significant less need. For example, while telephone penetration rate is nearly 94 percent¹¹ and homes passed by telephone service is nearly 100 percent, cable penetration hovers around 60 percent, despite coverage in excess of 90 percent. Therefore, one must view VDT services as having different market characteristics than telephony services. Video and telephony might compete for similar sets of customers, but these inherent services delivered by both groupings appears to satisfy the different needs of customers. Moreover, many elements of the VDT services will be marketed towards customer-programmers, that are distinctly different than the class of telephony customers that includes interexchange carriers (IXCs).¹²

In order to achieve protection against cross-subsidy, and to protect other video delivery competitors from predatory pricing, the Commission must pursue the following strategy:

¹¹ Telephone Subscribership in the United States, Industry Analysis Division, Common Carrier Bureau, Federal Communications Commission, April 1995.

¹² The treatment of a possible situation of functionally-equivalent transport services is discussed by MCI below.

1. Establish a distinct price cap basket for VDT services
2. Roll VDT services under price caps after one year, using the existing productivity factor, cost index, and consumer productivity dividend for the PCI formula.
3. Require that LECs separately account for VDT investments and calculate sharing for existing interstate services without contamination from VDT returns.
4. Create a separate Part 69 bucket for all VDT elements that will prevent the assignment of costs and investments to non-VDT access categories.

MCI will discuss these items more fully below

It is Premature to Anticipate Whether All Broadband Services Should be Held in the VDT Price Cap Basket

MCI believes that it is premature to decide at this time whether all broadband services should be included in the VDT basket. Obviously, the Commission, at this time will be unaware of what as yet unannounced services might be rolled out by the LECs. Further, it would be virtually impossible at this point to determine whether these unannounced services share the same technical and market characteristics as VDT services.

Future broadband services are nebulous at this time. However, in the Notice, the Commission asks whether “other broadband, transport-related services” should be folded into this basket, and, if so, under what criteria.¹³ This request for information

¹³ Notice at ¶ 12.

hints at the appropriate conclusion that transport of signaling, be it video, audio, voice, Internet access, or other is highly interrelated. As such, there might be a certain attractiveness to clustering transport-related rate elements in one basket, since the technical properties are very similar, and therefore the pricing of this transport should be non-discriminatory. However, the Commission must carefully examine the market characteristics and technical characteristics the transport services involved in such deliberation. The potential competitive landscape for video delivery, for example, is substantially different than the virtually monopoly the LEC holds over voice telephony and access-related services. By clustering video transport with voice transport, LECs would use whatever banding flexibility that was present to minimize the rates for the competitive service, while maximizing the rates for monopoly services. Even the clustering of all broadband transport services, without knowing *a priori* the degree of market competition for the underlying services, should be a significant reason for not establishing a broadband basket at the present time.

However, if the Commission were to find that certain transport components of services were in fact near identical in their concept, combining these sub-elements into a common basket could assist in the prevention of discriminatory treatment of different classes of customers. For example, if the Commission finds that VDT transport is functionally similar to existing transport services, the appropriate combination of transport services into a trunking basket could be useful. By requiring LECs to unbundle this transport, and to make it available to all parties, along with full resale provisions, the Commission could prevent LECs from manipulating the transport function depending on whether the customer was a video programmer or telephony-

access customer. Clearly the Commission's intent is to have efficient use of LEC investment -- and if transport facilities can be more effectively utilized by either access or video customers, the Commission should facilitate that flexibility.

The PCI Formula, Productivity Factor, and Consumer Productivity Dividend

The proper establishment of the appropriate Price Cap Index (PCI) formula and the associated productivity factor, cost of input measure, and consumer productivity dividend is at the heart of any price cap mechanism. A formula which mimics a competitive market solutions for pricing, taking into account changes in productivity and input costs, can promote the price cap goals of efficient allocation of resources, deployment of new services and technologies, and rewarding of efficient providers of access services.¹⁴ An ill-devised formula and overall plan can create problems regarding over and under earnings, unfair pricing practices, and negative impacts on ratepayers. In the case of VDT, a misalligned formula could cause access and telephony ratepayers to be charges higher rates than they would face in the absence of VDT. As a corollary, VDT customers might pay lower than justifiable rates, causing a competitive imbalance between programming alternatives of cable delivery versus VDT delivery schemes.

The Commission, in its Notice, correctly points out that VDT does not share the long history of access charges.¹⁵ VDT is a new service, coming to fruition without

¹⁴ First Report and Order, at ¶ 1.

¹⁵ Notice at ¶¶ 17-18.

the long historical period of access charges upon which the Commission was able to establish ranges of actual productivity. Also, VDT rates have not undergone multiple years of tariff review to which access charges have been subjected. Even those rates that have been filed to date have not undergone close regulatory scrutiny regarding the level of costs assigned and allocated to VDT services.¹⁶ As a final consideration, VDT capabilities are only slowly rolling out to the LEC customer base. While trials have been taking place, broad coverage of the LEC potential subscriber base will only be occurring over several years. Therefore, even in the early period there may be little revenue, expense, and investment data available to determine sound conclusions regarding these factors.

Based upon this lack of historical perspective and data, it would be virtually impossible for the Commission, or any other interested party, to derive reasonable estimates for productivity factors and consumer productivity dividends that are different from those already existing in the price cap formula.. The appropriate manner in which the Commission can address the reasonableness of the rates is through a rigorous tariff review process which attempts to arrive at cost-justified initial rates, followed by the traditional pattern of rolling VDT services into the price cap formula after the initial year. In a detailed sense, the Commission would evaluate with great scrutiny the initial tariff filings for VDT services. The appropriate review of

¹⁶ For example, Bell Atlantic has not allowed potential customers, or current ratepayers, to review the cost studies upon which their recently filed VDT rates are based. See In the Matter of Bell Atlantic Tariff Transmittal No. 741, MCI Petition to Reject, or in the Alternative to Suspend and Investigate, filed February 21, 1995

costs assigned to VDT, telephony, and joint use would enable the Commission to analyze the appropriateness of the initial rates. The process has already been described by the Commission in its Recon Order.¹⁷ A careful review would evaluate to what extent the LEC rates are either justifiable, or discriminatory, or offer the potential for cross-subsidy. After these rates have been in effect for one year, they would be adjusted pursuant to the price cap formula, using the existing productivity offset and input cost measure, the GNP-PI.

Initial Rate Setting

As discussed above, MCI firmly agrees with the Commission's tentative conclusion that the initial price cap rates be set through the new service rule process. MCI agrees with the Commission's tentative conclusion that VDT rates can be rolled into the price cap formula after one year's experience.

Service Categories and Banding

The Commission has asked for comment on the possible subdivision of VDT services into service category bands.¹⁸ MCI initially tends to believe that no further basket subdivision is required under the price cap treatment discussed above, as well as the sharing issues reviewed below. To the extent, however, that the Commission

¹⁷ Recon Order at ¶¶ 206-220.

¹⁸ Notice at ¶ 20.

wishes to ensure significant unbundling of the VDT rate elements to be offered by the LECs, it would be prudent to establish sub-categories specifically for this purpose.

Sharing Issues

There are two extremely critical aspects of sharing that need to be dealt with prior to the Commission establishing a sound price cap program for VDT. The first requirement, following from the issues described above, necessitates that the Commission require LECs to report rates of return for all services within their VDT basket. To that end, LECs would need to keep segregated records of all investments, revenues, and expenses associated with VDT. In addition to these requirements, the Commission would be required to establish new Part 36 rules that would constrain LECs to directly assign all VDT investments to the appropriate jurisdiction. Without such an assignment, interstate revenues from VDT services would become mismatched from VDT costs of service.¹⁹ If, in the alternate the Commission does not decide to require LECs to follow VDT-specific rules for separation of plant into state and interstate, the Commission could require LECs to calculate a total subject to separations rate of return for VDT to serve as an interim gauge for the recalibration

¹⁹ As described in the Recon Order, revenues from services that use “radio transmission” fall under the interstate jurisdiction, along with those revenues from services that transgress state boundaries through any means (§§ 121-123). Costs, on the other hand, will be allocated to the state jurisdictions based upon existing rules (§ 186). While some costs will be assigned under the existing rules based upon relative actual usage between state and interstate uses, a significant category of expense, loop investment, will not be directly assigned based on usage.

of rates. This interim measure would only exist until such time as the Commission can ascertain a reasonable productivity offset and consumer productivity dividend.

The second requirement for sharing is essential for the protection of existing access and telephony ratepayers, a prophylactic against cross-subsidy of VDT services by the LEC. The current rate of return calculations for interstate access services must be calculated without any contamination of VDT revenue, expense, or investments. As MCI has previously demonstrated, the sharing and backstop mechanisms of the current price cap mechanism are two avenues by which access ratepayers can be forced to implicitly cross-subsidize VDT services.²⁰ The Commission itself has recognized that VDT costs could impact the level of sharing available to reimburse access ratepayers for overpayment.²¹ Therefore, VDT elements should be excluded from the calculation of the interstate return from access services.

The Commission Must Establish a Distinct Part 69 Access Category for VDT

In order to implement the above-discussed requirement, the Commission must take measured steps to exclude VDT revenues, expenses, and investments from contaminating the accounts which the price cap LECs use to calculate their interstate return. In essence, the Commission must create a new Part 69 category. Without a separate bucket, carriers that book investment and expense to existing Part 32 and 36

²⁰ See In the Matter of Bell Atlantic Tariff Transmittal No. 741, MCI Petition to Reject, or in the Alternative to Suspend and Investigate, filed February 21, 1995, at p. 3.

²¹ Recon Order, at ¶ 223.

categories will see these amounts flow forward through the Part 69 process into existing Part 69 buckets. If these amounts flow into existing Part 69 categories, they would be used in the calculation of the interstate rate of return, and impact the amount of sharing and/or low end adjustments that could be required during a price cap filing. This could create a situation where access and telephony ratepayers cross-subsidize VDT rates.

Therefore, the Commission has two alternatives, since it has already indicated that it is not yet ripe to revisit Parts 32 and 36 of its rules.²² It can choose to require LECs to maintain totally separate accounts for VDT revenues, expenses, and investments and keep those dollar flows from entering the jurisdictional separations process and feeding into the existing Part 69 access category assignments. In order to do this, the Commission must allow ratepayers the ability to judge how individual LECs are assigning plant and expenses that are allocated either to VDT or joint telephony/VDT functions. Following this, the Commission must not allow price cap LECs from booking amounts from these subsidiary accounts to Part 32 accounts which feed into the LECs jurisdictional separations system and Part 69 access charge categories. In essence, the Commission will be creating a separate bucket, VDT revenue, expense, and investment, that is held out of the telephony categories so that existing telephony returns will be unencumbered with VDT costs. This separate bucket would form the foundation for a new Part 69 rate element category for VDT activity.

²² Recon Order, at ¶¶ 172 and 186.

The second alternative would allow LECs to book VDT expenses, investments and revenues to existing Part 32 categories, allow these dollars to flow through the separations process, the Part 69 access assignment process, and then use subsidiary accounting techniques to expunge these amounts from the final Part 69 access categories. MCI views this alternative as virtually unauditible and unworkable, and recommends that the Commission utilize the first alternative.

Conclusion

For the reasons discussed above, the Commission must establish a separate price cap basket for LEC VDT services. The Commission should utilize the new service rules to establish the initial rates for VDT services, and require that those services be rolled into the existing price cap formula after they have been in existence for one year. The Commission should create a new Part 69 rate category for VDT services, allowing carriers to allocate the costs of VDT directly to this bucket. Finally, the Commission must find that carriers offering VDT services should exclude the revenues, expenses, and investments of VDT from the calculation of interstate return that forms the basis for sharing and low end adjustments.

Respectfully submitted,


A handwritten signature in black ink, appearing to read "Michael Hydock", written in a cursive style.

Michael Hydock
Executive Staff Member
MCI Telecommunications Corporation
1801 Pennsylvania Ave. NW
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April 17, 1995

Statement of Verification

I have read the foregoing and, to the best of my knowledge, information, and belief, there is good ground to support it, and it is not interposed for delay. I verify under penalty of perjury that the foregoing is true and correct. Executed on April 17, 1995

A handwritten signature in black ink, reading "Michael Hydock", written over a horizontal line.

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CERTIFICATE OF SERVICE

I, Stan Miller, do hereby certify that copies of the foregoing Comments were sent via first class mail, postage paid, to the following on this 17th day of April, 1995.

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